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C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 005443

SIPDIS

TREASURY FOR OASIA - MILLS AND LEICHTER
NSC FOR MCKIBBEN
DEPT FOR E, EB/IFD, AND EUR/SCE

E.O. 12958: DECL: 08/25/2008
TAGS: EFIN TU
SUBJECT: MARKETS BUOYANT DESPITE WEAK BUDGET NUMBERS

¶1. (U) Classified by Deputy Chief of Mission Robert Deutsch for reasons 1.5 (B) and (D).

¶2. (SBU) Summary: January-July budget data, combined with a frankly skeptical assessment by a key budget official, suggest that the GOT will have difficulty meeting the IMF,s Sixth Review and end-year fiscal targets. Markets nevertheless remain buoyant, cheered by the prospect of U.S. financial assistance, Turkish contributions to the Iraq stabilization force, and the steady flow of positive numbers on inflation, the lira, exports and capacity utilization. End Summary.

Disappointing January-July Budget Numbers:

¶3. (SBU) On August 18, the GOT released revenue and expenditure data for July showing a weaker than expected primary surplus of TL 395 trillion (USD 282) million. From January through July, 2003 the Primary Surplus was TL 10.49 quadrillion (USD 7.49 billion). The government,s full-year 2003 target under its IMF program is TL 20.3 quadrillion (USD 14.5 billion) or 6.5% of GDP. With the fall traditionally a period of lower revenue collection, market analysts are skeptical that the GOT can meet the end-year target.

¶4. (SBU) In real terms, both revenue and expenditure were roughly comparable to the first seven months of 2002 however individual budget categories showed sharp movements in both directions. The GOT seems to have done reasonably well in cutting investment expenditure (down 28 percent in real terms), and not too badly in controlling the rise of the public sector wage bill: personnel costs increased 5 percent in real terms. There were, however, alarming increases in Social Security expenditure and tax rebates. Social Security spending increased 25 percent in real terms compared with January-July 2002 and spending on tax rebates jumped 39 percent in real terms.

Budget Official on Fiscal Problems:

¶5. (C) In a meeting with econoffs August 21, Ministry of Finance Deputy Budget Director Ahmet Kesik shared private analysts, view that the first seven months budget numbers were not good. Though Kesik did not seem overly concerned about the August 31 numbers, he seemed far more concerned about year-end 2003. Kesik explained that the kind of remedial budget actions the GOT took to pass the fourth and fifth reviews would be far more difficult towards the end of the year. Whereas the GOT had frozen spending in many areas earlier in 2003, to freeze spending the final quarter will only create public sector arrears in 2004, because line agencies have already committed to the spending. Kesik said more measures could be needed in October to able to meet the fiscal targets this year.

Social Security Headaches:

¶6. (C) Kesik said the problems with the Social Security system were so severe that the IMF understands it will take at least a year or two to fix them. The Bag-Kur, the Social Security system for self-employed workers, is in particularly bad shape, with payments exceeding collections, according to Kesik. Exacerbating the problem with Social Security collections, under IMF pressure, the GOT had raised premiums leading to increased resistance to paying. In Kesik,s view, the most important problem for Social Security is

attributable to the frequency and severity of downturns in the real economy. With crises every few years, employers have often closed their doors. In many cases, when firms rehire, employees are glad to get work whether they are on the books or off. Unemployment is officially eleven percent but Kesik believes this understates the problem because of severe underemployment.

Agricultural Sector Issues:

¶7. (SBU) According to Kesik, the agricultural sector is a particular problem for the Social Security system, especially the Bag-Kur. Kesik put the agriculture sector,s share in GNP at 16 percent, but said it accounts for 42 percent of total employment. Yet contributions to Social Security from agricultural employees are low since much of the employment is off the books. If employees do not contribute for 4 or 5 years they are removed from the system, but given current conditions Kesik claimed that many workers accept being removed from the rolls because they cannot afford to pay.

¶8. (C) Aside from Social Security-related problems, the ag sector subsidies also contribute to budget deficits. Kesik said the problem arose in part from a World Bank push for a change from production-linked subsidies to direct payments to farmers. Kesik lamented that the GOT had transitioned to direct payments without eliminating existing subsidies. He claimed that the direct payments scheme had led to questionable claims, and the Ministry of Finance was pushing for some minimal evidence that the recipients of the direct payments were actually farmers.

Tax Rebates:

¶9. (C) Regarding the sharp increase in Tax Rebates (para 4), Kesik only noted that Ecevit-era reforms had forced the Ministry to make tax rebates to exporters within a month. He also said there were rumors of corruption in tax rebates and suggested the IMF look more closely at this issue.

Organizational Issues:

¶10. (C) Kesik is convinced that the GOT would be able to more effectively manage its fiscal situation with a more cohesive bureaucratic structure, rather the than the existing division of responsibility between the State Planning Office (SPO), Treasury and the Finance Ministry. Though he enjoys excellent working relations with his colleagues in Treasury and SPO*-a fact cited by opponents of a reorganization*-Kesik said the effectiveness of an organization shouldn,t depend on individuals. Kesik confided that he had attended a meeting on the topic at which Minister Babacan had seemed sympathetic to a reorganization. Other ministers--and most senior civil servants--however, were opposed and the idea was shelved despite IMF pressure.

Markets focused on politics and the real economy:
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¶11. (SBU) Despite the discouraging budget numbers and the critical importance of the end-year primary surplus target, Turkish markets remain bullish. On August 22, the principal Istanbul stock market index, the IMKB 100, reached a high for the year at 12,001.8. More importantly, the benchmark bond traded below 40 percent before closing slightly higher at 40.3 percent on a compound basis. At this level, interest rates are the lowest since before the 2001 financial crisis and have come down dramatically in the past year, from a level of over 70 percent. Like the stock and debt markets, the lira, too continues strong, trading below TL 1.4 million per USD since August 13.

¶12. (SBU) The markets, enthusiasm seems to be based on a combination of political developments and real economy indicators, rather than public finance. On the political side, after reacting to to the approval of the Fifth Review and the IMF's extending Turkey's repayment reschedule, markets are focusing on the prospects for improved relations with the U.S. based on the discussion of Turkey contributing to the stabilization force in Iraq and signs of forward movement on U.S. financial assistance. With regard to the real economy, on top of the encouraging July inflation and export numbers, on August 21 the GOT announced that capacity utilization in manufacturing had risen to 80.9 percent. Moreover, the Central Bank released August 21 a favorable

report on expectations. The business people surveyed expect year-end CPI to be 22.4 percent, down from 23.0 percent in the previous survey released in early August.

¶13. (SBU) Though markets retreated slightly on Monday, the bulls returned on Tuesday despite the prospect of a large Treasury redemption on Wednesday. Treasury enjoyed great success in issuing TL 2.2 Quadrillion (USD 1.57 billion) of t-bills and bonds on Tuesday. Market analysts attributed the favorable reception in part to Treasury having a borrowing need below what markets had expected. After the Treasury,s bond and t-bill sales, the benchmark bond was trading at 39.84 percent.
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